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SUBJECT: UK FINANCIAL SERVICES AUTHORITY ADMITS FAILINGS RE NORTHERN ROCK

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¶1. (U) SUMMARY: An internal report by the Financial Services Authority (FSA) on the handling of the now-nationalized Northern Rock (NR) details multiple failings including: high turnover of staff supervising NR; inadequate staff; and infrequent contact with NR management. The report recommends adding supervisory staff, adding risk specialists to supervisory teams, and increasing contact between senior staff and large firms. While critical of the FSA's performance in this case, the report re-affirms the FSA regulatory philosophy of risk-based, outcome-focused regulation. Industry reaction is that there was a systemic failure at the FSA but that the report goes overboard with its mea culpa. The report completes the official inquiries into the handling of NR. The Bank of England (BOE) emerges unscathed. END SUMMARY

Background

¶2. (U) NR is a UK mortgage bank that grew over the past decade to be the fifth largest UK mortgage lender. It aggressively funded expansion through interbank short term borrowing rather than through customer deposits. When the subprime crisis hit last August, interbank lending dried up and NR had to ask the BOE for assistance as the lender of last resort. A depositor run on the bank ensued, prompting the NR crisis that ultimately led to the nationalization of NR in February. In October 2007, Hector Sants, Chief Executive of the FSA ordered an internal lessons-learned report on the supervision of NR during the period 1 January 2005 to 9 August 2007. That report was issued March 26, 2008.

The FSA Failings

¶3. (U) The report identified four key FSA failings in the case of NR. The first is a lack of sufficient supervision in following up on NR's planning for unexpected developments (stress testing) that identified the vulnerability of the NR business model. The second is a lack of adequate oversight by FSA line management of the firm's supervision. The third is inadequate resources directly supervising the firm. The fourth is the failure to ensure that available information on the risks NR was assuming was assembled and utilized to guide the actions of supervisors. The report concludes that the supervisory failings with respect to the NR case resulted in it not being classified as a high-impact firm and do not reflect the level of supervision generally of other high-impact firms.

Supervisory Enhancements Underway

¶4. (U) The report outlines seven supervisory enhancements that will be undertaken immediately. The first is creation of a new group of supervisory specialists to review the high-impact firms (those judged to face higher levels of risk). Second, supervisory staff engaged with high-impact firms will be increased, with a mandated

minimum level of staffing for each firm. Third, the existing specialist prudential risk department will be upgraded to divisional status and expanded. Fourth, supervisory training will be upgraded. Fifth, FSA senior management involvement in direct supervision will be increased. Sixth, focus increased on liquidity, particularly in the supervision of high-impact retail firms. Finally, emphasis raised on assessing the competence of firms' senior management. The Executive Summary of the report can be found at: http://www.fsa.gov.uk/pubs/other/exec_summary .pdf . Although the report is highly critical of the FSA supervision of NR, it concludes that the failings were not systemic. The recommendations relate to a more rigorous implementation of the supervisory framework that is already in place. The report finds no fault with the risk-based, outcome-focused philosophy of the FSA with its principles-based approach to regulation.

Industry Reaction: Systemic Problem or Just Poor Implementation?
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¶5. (SBU) At a March 28 meeting with with executives from several leading UK banks, Econoffs were told that the FSA went overboard with its mea culpa. They noted that FSA Chief Executive, Hector Sants, only was appointed in July, 2007 and said the report was a way for him to position himself with a clean sheet. While the report concludes that the NR experience validates the FSA regulatory philosophy, the bankers said the report points to a systemic failure and not just to a failure of implementation and lack of resources. In their view, the FSA system failed to move NR up the risk spectrum as its mortgage portfolio expanded. It should have gradually been classified as a higher risk (i.e. high impact) bank. The FSA system failed to do this. In the case of NR, a high risk bank was assigned a level of supervision appropriate for a low risk institution.

¶6. (SBU) Sants is using the report as a mandate to shake up both

the way the FSA is organized and its supervisory approach while justifying additional resources said the bankers. Last week's departure of Clive Briault, former Managing Director of Retail Markets at the FSA may have been part of Sants' clean sweep.

Comment

¶7. (SBU)While most financial service interlocutors expect it will be years before the government is able to privatize NR and put the crisis behind it, the FSA report marks the closing of the official inquiries into the matter. It follows the HM Treasury consultation in January on its review of the NR crisis. Among the members of the tripartite agreement that oversees the UK financial system, only Mervyn King, Governor of the Bank of England, emerges unscathed. He was the first to testify before the Parliamentary Treasury Select Committee and at the time, many expected he would be criticized for not pumping liquidity into the system to rescue NR. Now, the recommendations he made in his testimony are embodied in the HM Treasury consultation and the FSA has admitted it failed in its supervision of NR. The NR reviews have identified numerous failings, but none involve King or the actions of the BOE. END COMMENT

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